IDAHO
State Tax Commission

Bad Debt

Sales Tax Refund Claims in the Auto Industry

Introduction

Due to problems the Tax Commission has found in reviewing bad debt refund claims from auto dealerships and finance companies that finance auto sales, we are offering some guidance to help in future transactions.

Sales taxes these entities pay on sales that create accounts later found to be worthless due to customer default can be refunded to the extent that the bad debt contains uncollectible sales tax. However, the error rate on filed refunds is often much greater than what is allowed by the tax law.

Typical Errors Outlined

Typical errors sellers make when calculating the sales tax portion of existing debt include applying loan payments to late charges, punitive interest rates, and other penalty charges that occur when customers don't comply with the terms of the sales contract. To properly calculate a sales tax refund, the seller must only allocate loan payments between the original interest rate calculation and the principal balance of the loan.

The Tax Commission doesn't allow payments on auto loans to be applied to late charges, punitive interest, or other penalties because these charges weren't inescapable liabilities at the time of the sale, and they bear no relationship to the sales tax that was charged and paid to the Commission. Also at issue for auto retailers and finance companies claiming bad debt sales tax refunds are instances where the principal balance of the loan isn't revised by the auto dealership or financer after a vehicle is repossessed.

Review Shows Reporting Problems

Recently, the Tax Commission reviewed refunds claimed by auto dealerships on sales and use tax returns (Forms 850) filed during calendar years 2010 through 2012. This review revealed that the returns filed by some dealerships included an extraordinarily high rate of adjustments for bad debt issues. Here are some of the findings:

- Some dealerships incorrectly requested a refund for vehicles they repossessed and sold, or repossessed and didn't resell right away through a public or private sale. Idaho Sales and Use Tax Administrative Rule 35.01.02.063.03.b. provides that the repossession and retention of the vehicle satisfies the debt, and no bad debt adjustment is allowed.
- Some repossessed vehicles were transferred to related entities at an unrealistically low basis and later sold to customers at a substantially higher amount. The dealer then claimed a bad debt refund using the low basis from the transfer to the related entity, creating a significantly inflated refund. Cars were repossessed multiple times, with each repossession generating an additional Sales and Use Tax Return Line 7 adjustment for an inflated amount. These situations circumvent

Idaho Sales and Use Tax Administrative Rule 35.01.02.063.03.b., which provides that if the car is repossessed and retained, no bad debt exists and no sales tax refund is allowed.

What the Industry Should Do

The auto sales industry should follow these guidelines to comply with Idaho Sales and Use Tax Administrative Rule 35.01.02.063. (Bad Debts and Repossessions):

- Apply loan payments on a pro-rata basis only to the principal, interest, tax, administrative fees, etc., that are included in the original loan amount and are unrelated to the customer's future behavior in paying off the loan.
- In calculating a sales tax refund, don't apply loan payments to fees, penalties, increased interest, etc., which are punitive and occur because a customer didn't comply with the original sales contract.
- Don't request a bad debt refund if the vehicle has been repossessed but not resold.
- If a vehicle has been repossessed and is resold, make sure the sales amount used to reduce the principal balance of the loan represents the value of the vehicle as it's recorded in an arm's length transaction to a neutral third party.